The new prospectus regime: impact on debt capital markets

July 2017

On 30 June 2017 the new prospectus regulation (Regulation EU 2017/1129) was published in the Official Journal of the European Union (the "**New Prospectus Regulation**"). This is a key part of the European Union's capital markets union project, which aims to facilitate access to the European capital markets and increase their depth and liquidity. The European Commission hopes that the New Prospectus Regulation will simplify the current EU prospectus regime, reduce administrative burdens and increase efficiency. It is the most significant legislative development in the EU public debt capital markets since the original prospectus directive entered into force in 2005.

In this briefing we consider the key changes proposed and issues raised by the New Prospectus Regulation for participants in the debt capital markets. We also consider the impact that Brexit will have on these issues and the debt capital markets more broadly.

Timing and next steps

The New Prospectus Regulation will enter into force on 20 July 2017, but the majority of the provisions will not apply until 21 July 2019. It is hoped that this two year implementation period will give sufficient time to ESMA to prepare related secondary measures, competent authorities to create new processes and for issuers and other market participants to prepare themselves for the new regime.

Key changes to the prospectus regime:

- The general duty of disclosure test will be reformulated, potentially allowing issuers to make more tailored, concise disclosure.
- The content and format of summaries will be changed, limiting the length of summaries to seven pages and limiting to 15 the number of risk factors included in a summary.
- Risk factors will be required to be categorised according to their materiality.
- Issuers will be able to publish a uniform registration document which can be used both for the prospectus regime and the transparency regime.
- Issuers with listed equity will be able to publish simplified prospectuses for their debt issues.
- Brexit will not affect the implementation of the prospectus regime into the UK other than in relation to pan-European retail offerings.

Prospectuses and base prospectuses approved under the current prospectus regime prior to 21 July 2019 will be grandfathered.

Unlike the current regime, the new regime will be governed by a regulation rather than a directive which will therefore be directly applicable across the EU without needing to be implemented locally. The European Commission hopes that this approach, together with far more detailed secondary measures and an enhanced role for ESMA in ensuring supervisory convergence, will level the regulatory playing field across the EU.

Application and exemptions

The prospectus regime will continue to apply to: (i) offers of transferable securities to the public in the EU and (ii) admissions of transferable securities to regulated markets in the EU, in each case unless an exemption applies. A majority of the exemptions reflect the existing exemptions, though there are some important differences:

Avoiding the prospectus regime altogether?: Because the prospectus regime has been perceived to be onerous, in recent years issuers have increasingly sought to avoid the prospectus regime by ensuring that their offers of securities to the public benefit from an exemption (typically, the wholesale debt exemption) and by admitting their securities to a MTF. The extent to which issuers continue to avoid the prospectus regime using these exemptions will likely depend on whether the new prospectus regime is considered onerous. It is likely that in any event the London Stock Exchange's International Securities Market as well as Ireland's Global Exchange Market and Luxembourg's Euro MTF will continue to be attractive destinations for issuers.

The convertible debt loophole is closed: Under the current prospectus regime, issuers of convertible bonds typically avoid publishing a prospectus by issuing the convertible bonds in wholesale denominations and admitting them to a MTF. At the time the bonds are converted into shares, no prospectus is required even if new underlying shares are admitted to a regulated market, because of a specific exemption for admissions of shares resulting from the conversion of other securities. Under the new regime, this specific exemption will be capped at 20% of the class of shares already admitted to trading. This change will reduce the ability of issuers to undertake capital raising exercises without a prospectus. This change will apply from 20 July 2017, though shares resulting from convertible bonds issued prior to 20 July 2017 will be grandfathered and continue to benefit from the old exemption. Regulatory capital instruments which typically contain automatic conversion features triggered by regulatory capital-based events will continue to benefit from the exemption.

A new exemption for fungible debt: The existing exemption for small equity capital raisings under which an issuer may admit new

shares to a regulated market that are fungible with securities already admitted will be extended to debt securities and the threshold will be increased from 10% to 20% of the number of securities already admitted over a period of 12 months. In practice this exemption is unlikely to benefit most issuers of debt securities which can already issue fungible debt relatively easily, particularly under debt issuance programmes.

The general duty of disclosure

The current general duty of disclosure test, under which issuers are required to disclose "*all information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities*" has been reformulated.

The new test will require issuers to disclose "*necessary information which is material to an investor for making an informed assessment of: (a) the assets and liabilities, profits and losses, financial position, and prospects of the issuer and of any guarantor; (b) the rights attaching to the securities; and the reasons for the issuance and its impact on the issuer. That information may vary depending on any of the following: (a) the nature of the issuer; (b) the type of securities; (c) the circumstances of the issuer; (d) where relevant, whether or not the non-equity securities have a denomination per unit of at least EUR 100 000 or are to be traded only on a regulated market, or a specific segment thereof, to which only qualified investors can have access for the purposes of trading in the securities.*"

The new test, which specifically distinguishes wholesale debt from retail debt and refers to the nature of the investors, is a welcome development and may make prospectus disclosure shorter and more tailored to the specific needs of investors. Issuers should be mindful that under English law their liability for prospectus disclosure goes beyond the tests within the prospectus regime. Issuers will continue to have liability for negligent misstatements under the common law and misrepresentations under the Misrepresentation Act. Issuers should also be note that the contents of prospectuses are in practice driven as much by the expectations of the markets (and US legal requirements for US offerings) as they are by EU and UK regulatory requirements. It remains to be seen how the new test will be applied in practice.
Under the new regime issuers will also be required to present their prospectus in a "*concise*" form, in addition to the current style requirement to present their prospectuses in an "*easily analysable and comprehensible*" form. It is unclear how

competent authorities will apply this new requirement.

Retail debt – a new regime for summaries

The requirements for prospectus summaries are to change significantly under the New Prospectus Regulation. In particular, the length of the summary is to be limited to seven sides of A4 (or eight if there is a guarantee), the summary must contain no more than 15 of the most material risk factors, and it must be laid out in a way that is "*easy to read*", "*in language which is clear, non-technical, concise and comprehensible*" with content that is "*accurate, fair, clear and not misleading*". The precise content and format requirements are to be set out in a delegated act in due course. Additionally, under a debt issuance programme no summary will be required in the base prospectus, but rather it must be included in each set of final terms. Wholesale debt prospectuses will continue to be exempt from the requirement to include a summary.

The requirements for summaries under the current regime are considered to be too onerous, making summaries long and confusing. Inserting some more flexibility into the way that summaries can be drafted is therefore welcome, but the proposals remain too prescriptive and will continue to be costly for issuers without really benefitting investors. The specific thresholds of seven pages and 15 risk factors are arbitrary numbers which may not be appropriate for all transactions. Issuers may be concerned regarding additional liabilities (e.g. in selecting the most material risk factors or in complying with the non-technical language requirements). It may be that many issuers will continue to avoid the summary regime and restrict their offers to qualifying investors, undermining one of the policy objectives of the reform of the prospectus regime.

Those securities which fall within the Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs) and are therefore required to prepare a PRIIPs-compliant key information document (KID) will have the option to use their KID disclosure for some parts of their summary. This provision aims to lower the compliance burden on issuers by removing the requirement to publish disclosure that is substantially duplicative. However, in practice it is likely to be the case that most issuers seek to avoid the PRIIPs regime altogether by ensuring that they do not offer their securities to PRIIPs investors. The International Capital Markets Association has prepared *pro forma* legends for this.

Categorisation of risk factors

The New Prospectus Regulation will introduce some changes to the way issuers disclose risk factors within a prospectus. In particular, issuers will be required to categorise risk factors and then present risk factors in each category ordered by materiality (based on the

probability of their occurrence and the magnitude of their impact, which may be disclosed using a qualitative scale of low, medium and high). ESMA is required to develop guidelines which will set out further detail in relation to these categories and the specificity and materiality of risk factors.

If the risk factor categories developed by ESMA are more complex than the current categories (those relating to the issuer's business and those related to the securities) then the process of categorising risk factors will place additional burdens on issuers. Ordering risk factors by materiality will also have compliance costs without any clear benefit. The current practice, under which issuers already consider the materiality of risk factors and communicate that through the wording of the risk factor itself works well. Ordering risk factors by materiality will make it harder for issuers to order risk factors thematically or in a more logical way, which may end up making their presentation less helpful for investors. Prescriptive requirements for risk factor disclosure within the EU prospectus regime may also present some difficulties to issuers which offer securities in other jurisdictions and are thereby required to comply with other regulation. The recitals to the New Prospectus Regulation indicate that issuers should no longer be able to include generic risks in their prospectuses, but it remains to be seen how competent authorities will apply this.

The new universal registration document

Another material change in the New Prospectus Regulation is the universal registration document, a new concept which will allow certain issuers to maintain a generic registration document to function as the registration document for all its prospectuses, in a similar manner to shelf registrations in the US. This will be available to all issuers with securities trading on a regulated market or a MTF. The universal registration document will need to be filed annually. For the first two years it must be approved by the competent authority and thereafter an issuer may file it without prior approval. An issuer with a universal registration document will be granted "frequent issuer status", entitling the issuer to a faster prospectus approval process of five rather than ten working days, provided an additional five days' notice is given to the competent authority before submission of the prospectus for approval. Information can be incorporated by reference into the universal registration document and it can be updated by filing an amendment (although a supplementary prospectus is still required for amendments between the approval of a prospectus and admission to trading). Issuers which update their universal registration document within four months of their financial year end will be deemed to have discharged their obligation to publish annual accounts and issuers which update it within three months of the end of their half-year end benefit from a similar provision in respect of half-yearly accounts. The exact content

requirements for the universal registration document will be set out in secondary measures.

It makes sense to align the transparency and prospectus regimes, but this new feature may receive little take-up in the debt capital markets because it is limited by certain shortcomings and undue regulatory complexity. In particular, if the universal registration document has only been filed with the competent authority (rather than approved) it must be subsequently approved before it can function as the registration document for a prospectus. One of the key benefits, the "frequent issuer status", may in practice not offer any improvement on the service already provided by certain competent authorities, particularly given the advance notice requirement.

New simplified prospectuses for secondary issuances

Under the new regime for secondary issuances, issuers whose equity securities have been admitted to trading on a regulated market for at least 18 months and who issue non-equity securities will be able to publish "simplified prospectuses". The precise contents requirements of simplified prospectuses will be outlined in delegated acts in due course and prospectuses drawn up under this regime will also benefit from a reformulated general duty of disclosure test, relating specifically to the secondary issuance.

This new regime acknowledges that issuers with listed equity securities are already obliged to publish ongoing transparency and market abuse disclosure and it is therefore logical to consider their existing public disclosure when they issue debt. Extending the minimum disclosure regime for secondary issuances to debt issuers is a welcome development and, provided that the detailed contents set out within secondary legislation are proportionate, it is likely that many debt issuers will take advantage of it both for their base prospectuses and their standalone prospectuses.

Other changes and open questions

In addition to the significant changes described above, the New Prospectus Regulation will make numerous other tweaks to the current regime.

Definition of "advertisement": The definition of "*advertisement*" has been changed from "*an announcement…*" to "*a communication…*". It is unclear whether or not there is deliberate intention to widen the definition to capture private bilateral communications in addition to announcements made to a wide group of investors, such as road show presentations. If the advertisement regime is widened in this way, there is a risk that it becomes unworkable.

Tax disclosure: Recital 47 to the New Prospectus Regulation indicates that tax disclosure within prospectuses is inherently too generic to be of value to most investors and that prospectuses should therefore simply contain a warning that the tax laws of both the issuer and the investor may have an impact on the income received from the securities. This is a welcome change of approach and it hoped that the operative provisions in the secondary measures reflect this.

Trading platforms for low denomination debt aimed at qualified investors: Under the current regime, the content requirements for debt prospectuses depend on the denomination of the securities rather than the nature of the investor. This has resulted in the anomalous situation in which prospectuses for low denomination debt securities aimed at qualified investors are required to contain disclosure aimed at retail investors, raising compliance costs without any benefit. The New Prospectus Regulation aims to correct this anomaly, by aligning the disclosure regime for low denomination debt aimed at qualified investors with the wholesale debt disclosure regime, provided that the securities are admitted to a specific segment of a regulated market that can only be accessed by qualified investors.

Prospectus publication: Under the new regime prospectuses will have to remain published electronically for at least ten years from the initial publication date, long after any offer period will have expired and frequently after the securities have matured. The purpose of this requirement is not clear. Prospectuses will also have to contain a prominent warning stating when the validity of the prospectus will expire. Prospectuses published electronically must be published on a dedicated section of the website, along with related documents such as supplements, documents incorporated by reference and final terms.

Base prospectus regime: The current regime for base prospectuses has been largely left unchanged, though the New Prospectus Regulation allows base prospectuses to be comprised of securities notes and registration documents as separate documents. Some of the existing inefficiencies within the base prospectus regime, including the inability to incorporate by reference future financial information or supplement securities note information, have not been addressed.

Secondary measures

The New Prospectus Regulation is a framework regulation, setting out broad principles rather than technical detail. It therefore envisages that the prospectus regime will be completed by a range of secondary measures, including delegated acts and technical standards.

In February 2017 the European Commission mandated ESMA to begin work on delegated acts related to the new prospectus regime,

including in the first instance delegated acts relating to: (i) the approval of universal registration documents, (ii) the format of the prospectus, the base prospectus and the final terms and schedules defining specific information to be included in a prospectus, (iii) the content of the universal registration document, (iv) the content of simplified prospectuses and (v) the approval of prospectuses. Work will begin on delegated acts for the new equivalence regime at a later stage.

The European Commission has invited ESMA not to simply copy and paste the existing disclosure building blocks in Regulation EU 809/2004 but to verify whether or not these continue to represent an appropriate balance between investor protection and cost to issuers. Industry bodies such as ICMA and AFME have recommended that ESMA largely leave the existing building blocks as they are (given that issuers and advisors are familiar with them) but instead make them optional, giving issuers the freedom to decide whether or not each disclosure item is relevant to it in the context of its business and the securities and the revised general duty of disclosure test. This approach would certainly help make the prospectus drafting process more efficient and lower costs for issuers. If ESMA takes the approach of reviewing and re-writing the existing building blocks, but requiring issuers to comply with them, there is a risk that well-intentioned changes disrupt issuers and increase costs.

The New Prospectus Regulation also gives a direct mandate to ESMA to produce a range of technical standards, including in relation to: (i) content and format of key information to be included in a summary, (ii) omission of information from a prospectus, (iii) information incorporated by reference, (iv) prospectus publication, (v) the advertisement regime, (vi) the requirement for a supplement and (vii) the forms and procedures for the approval of prospectuses and universal registration documents.

It is expected that ESMA will launch its first consultation on the delegated acts and technical standards during July 2017 and that in any event the secondary measures will all be in force before the application date of the new prospectus regime.

Brexit and reforms to the EU prospectus regime

Based on the current timetable of the UK Government and the EU institutions, it is likely that the UK will leave the European Union on 30 March 2019, before the New Prospectus Regulation applies in full. This raises some interesting questions in relation to the application of the EU prospectus regime in the UK post-Brexit. The position of the UK Government is to ensure, by way of the European Union (Withdrawal) Bill that as a general rule the same rules and laws apply in the UK after the UK leaves the EU as they did

before. However, within the current draft of the European Union (Withdrawal) Bill, EU regulations are only considered "*operative*" to the extent that they apply immediately before exit day and therefore the New Prospectus Regulation will not automatically form part of "*retained EU law*" or have effect in domestic UK law post-Brexit. The Government is seeking to give itself powers both to add to the body of retained EU law from time to time and also to implement the EU Withdrawal Agreement and it might be the case that New Prospectus Regulation will form part of UK domestic law via one of these mechanisms.

Given that the EU's prospectus regime is a cross border regime, Brexit does introduce some other questions on the operation of the prospectus regime post-Brexit and the answers to some of these questions are likely to remain uncertain until there is further clarity on the new relationship between the UK and the EU

How will the existing acquis be incorporated into UK law? What does this mean for ESMA guidelines and questions and answers and judgments of the CJEU?

The exact way in which the existing prospectus regime *acquis* is incorporated into UK domestic law is uncertain. In due course amendments will need to be made both to FSMA 2000 and the FCA handbook. In order to ensure legal certainty and continuity, all existing ESMA guidelines and questions and answers should continue to apply in the UK post-Brexit (presumably these will be inserted into the UKLA Knowledge Base) and all existing judgments of the CJEU will have precedent value in the UK courts.

What will be the status of prospectuses approved prior to the Brexit date be in the UK and the EU after the Brexit date?

In order to ensure continuity, the UK Government will want to ensure that prospectuses and base prospectuses approved by the UKLA or passported into the UK prior to the Brexit date remain valid in the UK after the Brexit date. It is hoped that this will either be confirmed as part of the European Union (Withdrawal) or separately by the FCA. It is also hoped that the EU takes a similar approach.

Brexit and prospectus passporting: The prospectus regime contains passporting provisions whereby a prospectus approved by one competent authority (in the home Member State) can be used elsewhere in the EEA (the host Member States) with minimal notification requirements. After Brexit, the UK will be a "third country" for the purposes of the prospectus regime and therefore issuers will no longer be able to passport a prospectus approved by the UKLA elsewhere in the EU.

In the debt capital markets, passporting is only necessary for pan-European retail offers. Wholesale issuers typically offer securities throughout the EEA on the basis of the

wholesale debt exemption, which will continue to allow cross-border offers of wholesale debt that are exempt from the requirement to publish a prospectus, either from the EU to the UK or from the UK to the EU post-Brexit. Those issuers which make pan-European retail issuers may decide to have their prospectus approved by a competent authority in the EEA post-Brexit.

After Brexit, in order to encourage investment into the UK, the UK could unilaterally allow inward passporting from the EEA. The UK could also extend inwards passporting of prospectuses to other jurisdictions which have regimes that the UK considers meet international standards, for example the US, Australia or Singapore.

Brexit and the equivalence regime: The prospectus regime contains equivalence provisions whereby the competent authority of a home Member State may approve a prospectus drawn up in accordance with third country legislation provided that (a) the information requirements imposed by the third country legislation are equivalent to the prospectus regime and (b) the competent authority of the home Member State has concluded a cooperation agreement with the supervisory authority of the third country. The Commission is empowered to specify equivalence criteria and adopt implementing decisions in relation to third country legislation. In February 2017 the Commission mandated ESMA to provide technical advice on general equivalence criteria within 18 months. This option, which may effectively allow passporting of UKLA approved prospectuses into the EEA post-Brexit, may be available to the UK given that at the date of Brexit UK regulation will be identical to the prospectus regime. However, it is difficult to see this being of significant practical benefit to DCM issuers or the capital markets in the UK.

Brexit and documentation issues: DCM issuers should continue to ensure that Brexit is appropriately documented in their prospectuses. Depending on the nature of the issuer, it is widespread market practice to include a Brexit related risk factor within prospectuses. Issuers should also ensure that covenants within trust deeds and agency agreements and the terms and conditions of bonds will not be breached by Brexit.

What will the new relationship between the UK and the EU look like for the debt capital markets?

The new relationship between the UK and the EU is one for negotiation and therefore uncertain. The Article 50 notification sent by the UK Government to the EU confirmed that that the UK Government's position is for the UK to leave the single market, to ensure that the UK continues to have control over its own regulatory framework for financial services. However, the result of the UK General Election has called this plan into question once more. Various industry bodies and lobbyists have

argued that the UK and the EU should continue to cooperate over financial services regulation and supervision going forwards and in particular for there to be transition and implementation arrangements.

A new prospectus regime for the UK post Brexit?

The prospectus regime probably does not operate at a regulatory optimum but it also does not represent a significant burden for most issuers, which are able to structure their offers or admissions to avoid it if need be. There is therefore some scope for the UK to improve the UK prospectus regime post Brexit, while complying with IOCSO principles of securities regulation, but this is unlikely to be a key priority.

Conclusion

While a majority of the changes to the prospectus regime are welcome and helpful it is likely that they will not make a significant difference to the cost and time of accessing the capital markets in the EU. As such the reform represents a missed opportunity and arguably the regulatory balance between investor protection and ease of capital raising for issuers still needs recalibration. There is also a risk that the plethora of secondary measures envisaged by the regime will end up creating undue regulatory complexity and thus have the perverse effect of incentivising issuers to avoid the prospectus regime altogether.

The aims of the capital market union - breaking down barriers to investment and capital raising between and within EU member states – are certainly laudable. Until we have further clarity on the various secondary measures the jury is still out on whether or not the aims can be achieved.

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